



# WARWICK FINANCE SOCIETIES



## Market Wrap-Up

Week ending December 16, 2012



Warwick Investment Club



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UK

## Britain's Economic Quagmire

*By Melson Chun, Analyst, 2<sup>nd</sup> year Law*

The quote by the Economist that hit the newswire recently pretty much summed up the current predicament of Britain. It can also be seen as the British standard response to the question "How's it going?": "Nothing much."

The British economy has pretty much been flat over the past 3 years, recently dipping back into recession, but not to such extent that revival requires herculean effort. Macro projections has suggested that overall GDP might be flat for the year 2012 as a technical rebound in Q3 (0.5% growth) seems to have given way to zero or negative growth in Q4. George Osborne's recent comments that austerity will last beyond its current target, from 2014 to 2018, and a series of impending spending cuts and tax increases that is due to be announced ahead do not help in adding more pessimism to the gloom outlook for the British economy.

Confidence in the integrity of the financial services industry in the City of London might also have taken a huge setback in the wake of the recent revelations from some of the largest players in the world. The LIBOR fixing scandal that shocked the world led to the resignation of Barclays' CEO Bob Diamond. Outsized positions in Credit Default Swap in the market led to the resignation of Ina Drew, J.P. Morgan's Chief Investment Officer and might potentially rack up to USD 9 billion worth of losses, actual sum yet to be determined. On the same breath, UBS rogue trader, Kweku Adoboli, who has recently been jailed for 7 years, accumulated over USD 2 billion worth of unauthorised trading losses and led UBS to be slapped with a fine of over USD 40 million by the Financial Services Authority. Apart from unauthorised trading losses, there are also serious doubts about the regulations that govern the operations of the bank. Leading British bank, HSBC, recently agreed to pay USD 1.9 billion to the U.S. federal authorities in exchange for dropping the criminal indictment against the bank. Evidence found suggests that HSBC might be guilty as a facilitator of money laundering as standard practices have not been followed. Standard Chartered was also fined USD 400 million for hiding certain transactions from the federal authorities. In light of all this, coupled with the unresolved issue of bring the Greek debt burden to sustainable levels, it is

highly unlikely that Britain can count on the financial services industry for a speedy recovery.

There is also an occurring phenomenon where international corporations are increasingly shifting their operations East, towards Asia where most of the thriving emerging economies are located. For example, law firm Simmons & Simmons recently announced opening a Singapore office in the flawless nation state. Withers also cite the turmoil in Europe as the reason for its slow moving activity in its London office and relies on the Asia-Pacific to channel work back to the London office.

Politically, the long-standing, unresolved stand-off that Westminster has against Brussels will not do Britain any good. For the uninformed, Britain has adamantly refused to cede any more control to Brussels for fear that additional oversight from the Euro-zone might hamper Britain's interest and long-term viability in the Euro-zone. Last month, David Cameron staunchly stood against the rest of the 26 Euro-zone leaders in a budget that was aimed to rescue the common euro currency. London demands that spendings are to be cut further before it will support the fiscal budget. Today, it seems that a compromise between both parties is unlikely to be met anytime soon. In the extremely unlikely situation where Britain exits the Euro-zone, the nation would save about USD 13 billion a year in terms of net budget contribution to the common cause. Freed of common agricultural policy, foodstuff would become cheaper as well. Yet, these gains would be outweighed by the access to the common market which Britain depends on for more than half of its exports.

Europe is no longer the thriving economic club that Britain signed up to join 40 years ago. Britain is no longer willing to cede any more of its sovereignty to Brussels. The financial service in the City has taken a huge beating since the financial crisis in 2009 – what awaits Britain then?

## Europe

# Banking Union

## Wings for the EMU

*By Wodzik Kicinski, Analyst, 2<sup>nd</sup> year Economics*

After creation of the Economic and Monetary Union (EMU) some, like euro architect Tommaso Padoa-Schioppa, drew attention that the three-letter acronym is the same as a name of an Australian ostrich. Today, with an unfading threat of the European Union (EU) break-up this comparison becomes even more relevant. Just as an emu, a bird that cannot fly, the EMU is a union whose states cannot converge. The agreement reached by 27 EU finance ministers on Thursday December 13th to cede power to a common bank supervisor is a step towards more integration and a banking union. But is it enough to make the EMU fly?

The Single Supervisory Mechanism (SSM) will come into life in March 2014. It envisages the European Central Bank (ECB) and a new supervisor authority under its auspices taking over direct control of up to 200 eurozone banks, with assets of more than €30bn or representing over one fifth of a state's national output. The common supervisor's powers would include intervening in these banks and providing instructions for national supervisors. A possibility for a recapitalisation of troubled banks by the ECB before 2014, awaited by countries such as Spain, would be possible only on request of the European Stability Mechanism (ESM) and requires unanimous decision by the SSM member states. Thus access to ESM's €500bn rescue fund will be given to banks only under an emergency and such a case was described by Wolfgang Schäuble, German finance minister, as an "unlikely scenario".

Although the common supervision affects only 17 eurozone members the euro outsiders did not want to lose control over the nascent banking union. To avoid the eurozone dictating the terms of the cooperation to the non-eurozone states the SSM will have a "double majority" voting system. It means that decisions have to be accepted by both the euro block and the outside states. This solution satisfied different interests in the outsider group. Britain was granted safeguards to protect the City of London, whereas countries such as Poland, who aspire to join the project in the future, were given enough clout to have its say and avoid a clear division into a two-tier Europe.

Common supervision is the first step towards a greater project of integration – the banking union. The progress made during the summit provides reasons for optimism but at the same time exposes the unsolved issues – new challenges European leaders have to face. The questions that arise refer to fate of the remaining 5800 banks which remain under domestic supervision, unclear process of resolution of failing banks and whether the banking union will include common deposit guarantee scheme.

Especially deposit insurance and possibility to use ESM resources for recapitalisation can cement financial integration as these decisions will enable to break a link between banking sector crisis and a sovereign crisis. So far banks were European during good times and turned national during such crises. It resulted in balance of payment divergence due to capital outflows from the South to the North. More risk sharing can decrease the discrepancies between weaker Southern states and the Northern core but its implementation requires decisive political actions.

While the direction of reforms is quite clear for the markets the perplexing question is rather its pace. Looking at a political calendar it is clear that Chancellor Angela Merkel will try to avoid such decisions before autumn 2013 elections. In a similar way other core countries are expected to try to postpone giving up their sovereign powers to the ECB as they have to appease voters' discontent.

Finally, even assuming the best case scenario of a banking integration in Europe it is crucial to understand that a well-functioning banking union is not a sufficient condition for the EU recovery. Even though it will increase the sustainability of the eurozone it does not provide necessary initiative that can really change the gloomy outlook for Europe.

## Macro Strategy

# Trends to Watch for 2013

*By Daryl Chia, Editor-in-Chief, 2<sup>nd</sup> Year BSc MORSE*

As 2012 comes to close, we count our blessings this Christmas and see how the world so narrowly averted calamity as the markets maneuvered between uncertainties most unprecedented. Macro and policy driven risk-on/risk-off trading presided over the year, thrusting the sea of financial assets about in a correlated symphony – all to tune of the U.S. debt-ceiling showdown, Greek debt restructuring, Chinese slowdown, and unconventional monetary largess lead by Bernanke's Rooseveltian resolve. Alas, will 2013 be any more predictable? In the first of this two part article, we illuminate two key themes to look out for in the New Year as we attempt to navigate the ever changing 'normal'.

### 1. Will 2013 see the U.S. out of its quagmire?

As the stalemate continues over the fiscal cliff, economic data from the U.S. remains mixed. GDP growth in the third quarter stood at a healthy 2.7% annual rate but is forecast to fall to a sub-2% stall speed in the fourth quarter due in part to Superstorm Sandy, while in November, nonfarm payrolls stood at +146,000 and unemployment at a 4-year low of 7.7%, only somewhat negated by the 350,000 increase in discouraged job seekers.

Will 2013 see the U.S. out of this quagmire? It depends. Concerns over the drawn out or failed resolution of the U.S. fiscal cliff – the barrage of tax increases and spending cuts that amount to up to 4.3% of GDP – have the potential to crimp capital expenditure and consumer confidence further. Consumer confidence, which typically lags capital expenditure, have in fact begun to take a dip from the mid-80s to mid-70s – not a good sign in an economy where personal consumption constitutes 70% of GDP. In that respect, even the most benign of forecasters expect a more than 1% cut in 2013 GDP to stall-speed levels.

Further, as developed markets embark on a synchronised bout of fiscal austerity, fiscal multipliers are likely to grow – to some instances above 1 – as the IMF so warned in an [October report](#) and reinforced in a [December working paper](#). This implies that the negative knock-on effect front loaded fiscal austerity has on growth could be larger than

what politicians and the markets currently expect, and perhaps even larger than the initial fiscal adjustments. Such fiscal retrenchment is even unlikely to be countered by Bernanke's unconventional monetary largess – commitment to QE and ZIRP can merely draw a line under economic activity and cannot contribute to growth if the monetary transmission mechanism remains broken in a liquidity trap.

Lastly, external circumstances continue to add to the uncertainty. Conflict in the Strait of Hormuz and Iran's nuclear ambitions in the volatile Middle East promises to keep oil prices elevated above where demand and supply fundamentals imply, potentially sapping corporate profits and disposable income further. As well as that, the U.S. can hardly expect to export itself out of its quagmire – which brings us to the next source of uncertainty

## 2. Hard landing, or not?

After a rout of contraction in manufacturing as reflected by PMIs earlier in the year, the Chinese economy has begun to show signs of stabilisation. November flash PMI readings came in at above 50 – the threshold for expansion – for the first time in 12 months. Meanwhile, post leadership-transition, inflation has remained muted, leaving scope for expansionary policy in China.

As some say, however, a point does not make a trend – it remains to be seen if, under the leadership of Xi Jinping, China can rebalance its investment-led growth model into a sustainable consumption led one while avoiding a hard-landing. Going forward, fiscal policy in China will likely reflect the new leadership's aspirations of increased social spending and wealth redistribution via transfer payments to households. Given such an ambitious budget, the precarious debt positions of the local governments and the sizeable amount of potentially non-performing loans in the Chinese banking sector built up over the crisis-fighting period of recent years, it remains an open question as to whether the Chinese government can invest its way out of a hard landing if property prices resumes their fall and private consumption does not pick up the slack in time. In any case, as the positive effects of monetary and fiscal easing this year starts to wane in mid-2013, analysts will be watching the 'man-made' (as per Li Keqiang's own words) macroeconomic statistics along with other indices that are less prone to manipulation, such as the constituents of the '[Li Keqiang Index](#)', which is not painting a good picture.

*Stay tuned for the 30<sup>th</sup> Dec issue of the WIC Market Wrap Up for the 2<sup>nd</sup> part of this article.*

## Investment Strategy

# The January Effect

## How you should put Santa's gifts to work

By Elliott Anderson, Co-Editor, 3<sup>rd</sup> year BSc of Management

I know, we're barely two weeks into December (and one into our holidays) and I'm already talking about January. Whilst for most of you it's a month of essays due dates (and the typical 'why did I not do these over the break?' self-questioning), January is known as that yearly anomaly on the markets when stock prices generally increase over the month. An overview of the financial press will show you that the January Effect is assumed as a 'given' opportunity. It's only a matter of time till we get articles about "Playing the January Effect", targeting retail investors.

But what's the evidence behind it (if any)? If it is such a recurring phenomenon, should you be investing all of your gifts from Santa on the market?



*"Stocks? I was looking for stockings!"*

The January Effect was first observed in, or before, 1942 by investment banker Sidney B. Wachtel. He observed that since 1925, small stocks have outperformed the broader market in the month of January, with most of the disparity occurring before the middle of the month. This market anomaly is often used as an argument against the Efficient Market Hypothesis.

The efficient market hypothesis predicts that security prices follow a random walk; it should be impossible to predict future returns based on publicly available information. Specifically, it should be impossible to predict changes in stock prices based on past price behavior. From an econometrician's perspective, various attempts have been made to prove this effect. Hypothesis examining short term serial correlations in stock prices have however not been significant (consistent with random walk theory).

The most common explanation is that historically, these are stocks that were sold for tax reasons late in the prior calendar year and repurchased the following January because investors still think the stocks are fundamentally attractive. Known as the wash rule (a sale of a security (stock, bonds, options) at a loss and repurchasing the same or substantially identical stock shortly before or after. The idea is to make an unrealized loss claimable as a tax deduction, by offsetting against other capital gains in the current or future tax years.), in some tax codes, tact rules have been introduced to disallow the practice, e.g. if the stock is repurchased within 30 days of its sale.

However, this may not be the entire explanation, since the January effect is also observed in Japan where no capital gains tax or loss offsets exist, or for example in the UK where tax years begin on April 1 and July 1<sup>st</sup> respectively.

Due to the uncertainty about 2013 tax rates, it is possible that we are seeing some stocks getting set up for a large-cap version of the January effect. In this case, the selling pressure could be coming from investors wanting to realize long-term gains at the known tax rate of 15%, rather than risk a potentially higher tax rate in 2013.

Market observers don't get detailed reports on why a stock is being sold. As you know, online discount brokers do not ask you why you're selling when you place an order to do so. Thus, we rely on a combination of news events, surveys and analysis to identify plausible.

Further explanations claim it is considered a good time for fund managers to re-organize their portfolios (New Year's resolutions on one hand, and having rested with the family for the break on the other). Nevertheless, this anomaly is rarely played by important investors, in particular due to transaction cost and the fact it is popular, making positions difficult to discreetly build and unwind. The popularity of this effect means people are buying these earlier and earlier, whilst suckers coming in late keep the price high before they tumble.

Rather than gamble on this anomaly, spend Santa's cash or invest in inflation-indexed bonds, as QE4 (or iEase4) in the US and pledges from Japan's new government to bring unlimited monetary easing will likely lead to high inflation.



*What goes up must come down: "Must be the 'after-January' effect..."*

## Bonds

# Poor Ratings

*By Swasti Gupta, Analyst, 2<sup>nd</sup> year Economics*

Standard & Poor's ratings agency joined Fitch and Moody's in changing the outlook for the UK's AAA credit rating to negative on Thursday 13th December. Following the news, UK government 10 year bond yields reached a 13 month high compared to German bunds with a spread of 53 basis points, but will this be enough to deter investor sentiment.

The move comes in response to the Chancellor's autumn statement earlier this month, where George Osborne announced that economic recovery will be slower than forecasted and the UK will not meet the government debt target as planned by 2015. The UK has been a safe haven for investors amidst the European sovereign crisis, but could now face higher funding costs in the in the coming weeks as result of the negative outlook (which implies a potential downgrade over the next 6-24 months).

### **A negative outlook for the Euro zone**

France's credit rating downgraded from the prized AAA status by Moody's Investors services on 19th November due to weak economic recovery and loss of competitiveness. Though this initially increased the risk associated with (and so potential yields of) French bonds, markets soon realised that they were underpriced and bond yields have since declined 23 basis points to 1.96%. Furthermore, yields rose on Friday when S&P announced that they would stick by their AAA rating but place a negative outlook on France.

One month earlier on 11th October, S&P downgraded Spain's rating to BBB- (the lowest of the investment grade) with a negative outlook due to poor fiscal control, weak growth prospects and lack of direction from euro zone policies. However, on the back of the downgrade investors expected another Spanish bailout, which would entail the European Central Bank buying Spanish bonds, and effectively enforcing a price floor. The week ended with Spanish yields on a 6 month low at 5.608%.

Perhaps the most amazing success story after downgrades and bailouts has been that of Ireland, which re-entered the bond markets earlier this year on 26th July at the same rating that it had received (S&P BBB+) prior to the bailout. Lower than expected yields on 10 year bonds (6.10%) reflected optimistic investor sentiment despite Moody's speculative grade rating of Irish bonds. Ireland's aim to be fully funded by capital markets in 2014 could be helped by the negative outlooks placed by CRA's on competing sovereigns such as the UK and other Euro zone countries. This in turn depends on whether CRAs can measure accurately the relative risks and so fair price of each country's bonds. And above all, on whether investors share this sentiment.

### "The ABC's of ratings scales"<sup>1</sup>

Credit ratings agencies (CRAs) use a combination of mathematical models and analysis to categorise debt (bonds and other fixed income investments) into ranges of investment grade and speculative grade ("junk" bonds). Investment grade securities carry a lower level of relative credit and default risk as they face less financial uncertainty than speculative grade securities. Though this does not guarantee against default, it is based on the CRA's assessment of the issuer's ability to pay back "in full and on time". Factors to be considered within this assessment include future cash flows, seniority of pre-existing debt, and industry conditions in which the issuer operates. When rating a sovereign or national government, factors are extended to include political risk, monetary stability and overall debt burden.

Sortable Table Key	Moody's	Fitch	S&P
Highest grade credit	Aaa	AAA	AAA
Very high grade credit	Aa1, Aa2, Aa3	AA+, AA, AA-	AA+, AA, AA-
High grade credit	A1, A2, A3	A+, A, A-	A+, A, A-
Good credit grade	Baa1, Baa2, Baa3, Baa4	BBB+, BBB, BBB-	BBB+, BBB, BBB-
Speculative grade credit	Ba1, Ba2, Ba3	BB+, BB, BB-	BB+, BB, BB-
Very speculative credit	B1, B2, B3	B+, B, B-	B+, B, B-
Substantial risks - In default	Caa1, Caa2, Caa3, Ca	CCC, CC, C, RD, D	CCC+, CCC, CCC-, CC, C, D

Figure 1: Reuters European Sovereign Credit Ratings

<sup>1</sup> STANDARD & POOR'S GUIDE TO CREDIT RATING ESSENTIALS

CRA's and in particular the big three (Moody's, S&P and Fitch) have continued to come under fire in the aftermath of the financial crisis. Many argue that they have too much influence in volatile markets and should be held accountable for failing to warn about the risks associated with the securitised assets such as mortgage backed securities. Perhaps the pinnacle was reached when constant proportion debt obligations (highly structured securities) were given the triple A rating, later found to be the result of a modelling error. The event highlighted not only the over-reliance on ratings for structured products, but also exposed structuring of debt products could exploit modelling techniques to ensure high returns and a high rating.

While the services provided by CRA's to standardise the mass of increasingly complex corporate and sovereign debt are vital for investors, there is ongoing debate over regulation and increasing competition within the ratings industry. The big three between them own 95% of the market share, with Moody's and S&P accounting for 40% each. Increasing competition and rules such as mandatory rotation for rating complex structured finance products is expected to increase transparency and reduce conflict of interest which currently arises due to the "issuer pay" model. This comes in addition to the previous rules set out in the Dodd Frank Act 2010 which aims to replace ratings with other, perhaps more accurate risk measures when determining bank reserves. However, in the absence of more appropriate measures, ratings agencies will continue to play a vital role in the pricing of fixed income products.

## Europe

# Should Europe stay on the austerity course?

*By Andrei Damaschin, Co-editor, BSc Accounting and Finance*

The eurozone is living through lean times, but there is light at the end of the tunnel. On the one hand the short-term economic outlook remains weak. On the other hand, there are signs that confidence is returning. Ireland has returned to the debt markets. In September more private capital moved into Spain than out for the first time in 15 months. And Italy recently sold 10-year debt at the lowest yield since 2010. That was clear recognition of the resolve shown by Mario Monti's government to boost competitiveness and pursue sound public finances. With Italian bond yields on the rise again after Mr Monti's decision to stand down, it is also a reminder of the need to maintain resolve in the future.

The progress made reflects important decisions at both the national and European levels. These decisions have begun to rebuild confidence, calming markets and countering fears of a collapse of the euro. Far-reaching structural reforms are helping to rebalance the eurozone economy. Progress is tangible: current account imbalances among eurozone members have fallen markedly, as competitiveness lost by some members in the decade before the crisis is regained. It is true that the correction of current account imbalances has so far come predominantly in deficit countries, but this is no surprise given the scale of the challenges they face. As John Maynard Keynes noted before the Bretton Woods talks, such adjustment is "compulsory for the debtor and voluntary for the creditor".

This does not invalidate the case for a more symmetrical external rebalancing within the eurozone, involving creditor as well as debtor countries. The European Commission has said surplus countries should implement reforms to strengthen domestic demand. Germany could do this by opening up its services market and by encouraging wages to rise in line with productivity, two of the recommendations made to Berlin by the EU Council last July.

But at the same time, we should be aware that the eurozone is neither a small open economy nor a large closed one, but a large open economy that trades a lot with the rest of the world. This means adjustment channels are influenced significantly by global

economic interdependence. A reduction of surpluses in the north will not lead automatically to a corresponding increase of demand for exports by the south.

The principal beneficiaries of greater German demand would be the central European economies closely integrated into Germany's supply chains. Studies suggests that a 1% increase in German domestic demand would improve the trade balance of Spain, Portugal and Greece by less than 0.05% of gross domestic product. This would not get us very far, which is why policies to enhance competitiveness – both structural and cost-related – remain crucial for the adjustment and rebalancing of the eurozone.

The case for a significant fiscal stimulus in Germany, as some call for, is also weak. The country will de facto have a much less restrictive fiscal stance in 2013 than the rest of the eurozone: the structural budget balance is expected to be little changed in Germany but to increase by 1 percentage point of GDP in the eurozone as a whole. Berlin's fiscal stance is also fully in line with the recommendations made by other organisations, such as the International Monetary Fund, and promotes growth-friendly components of spending such as education and research, as consistently called for by the European Commission.

In spite of persistent misperceptions to the contrary, the EU's reformed stability and growth pact takes full account of evolving economic conditions. Each country's consolidation effort is specified in structural terms, removing the effects of the business cycle and one-off measures, and takes into account the country's fiscal space and macroeconomic conditions. If growth deteriorates, a country may receive extra time to correct its excessive deficit, provided that the agreed consolidation effort is being made. Such decisions have been taken this year for Spain, Portugal and Greece.

We also intend to explore further ways, within the rules of the stability and growth pact, to accommodate public investment in our assessment of national fiscal plans. In order to overcome the crisis and restore confidence, we must continue to remove structural obstacles to sustainable growth and employment; pursue prudent fiscal consolidation; and turn bold thoughts into convincing actions when redesigning and rebuilding our economic and monetary union. In short, we need to stay the course and pursue decisive reforms in our member states and deeper integration in the eurozone.

## Note from the Team

We are always looking to improve; our team of analysts is dedicated not only to producing exceptional research but also to tailoring information to what best suits our readers.

We would appreciate any helpful feedback you may have as we strive to grow the quality and usefulness of our weekly market wrap-ups.

Please send this feedback to **D.Chia@WFSocieties.com** and the subject as “Fortnightly Wrap-up Feedback”.

Many thanks.

The Warwick Investment Club Research Team

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